

MID-TERM REVIEW OF MONETARY POLICY STATEMENT 2004

1. Introduction

- 1.1 *The mid-term review of the Monetary Policy Statement (MPS) has three main objectives. First, it presents a progress report on the extent to which the objectives of monetary policy, outlined in February 2004, have been achieved in the first six months of the year; second, it examines the prospects for financial and economic developments during the remainder of the year and evaluates whether or not there is need for a change in the policy stance; and third, it informs stakeholders of the key issues that are likely to be relevant to policy formulation in the second half of the year.*
- 1.2 *In setting the 4 – 7 percent inflation objective for 2004, the Bank considered, among others, inflation in trading partner countries, and the inflationary impact of the 7.5 percent devaluation of the Pula in early February. At the time, forecast trading partner inflation for 2004 was lower than that for 2003, implying a need to lower the inflation objective in order to meet the related objective of a stable real effective exchange rate. However, in light of the devaluation of the Pula, it was considered unrealistic, and potentially costly in terms of output and employment, for the Bank to try to counter the full inflationary fall-out of the devaluation over a short period. The Bank, therefore, set an inflation objective of 4 – 7 percent to allow for a gradual adjustment but at the same time ensuring that the gain in competitiveness that the devaluation intended to achieve would not be eroded by higher inflation.*
- 1.3 *In view of the fact that the main objective of monetary policy is to control demand-induced inflation, the Bank focuses on the growth rate of commercial bank credit, which contributes to domestic demand pressures and can be influenced by monetary policy. Although it does not have a direct influence on fiscal policy, the Bank also monitors the level of government spending, focusing on the rate of growth that is considered non-inflationary, as it accounts for a large component of consumption and investment expenditure.*

2. Outturn for the First Half of 2004

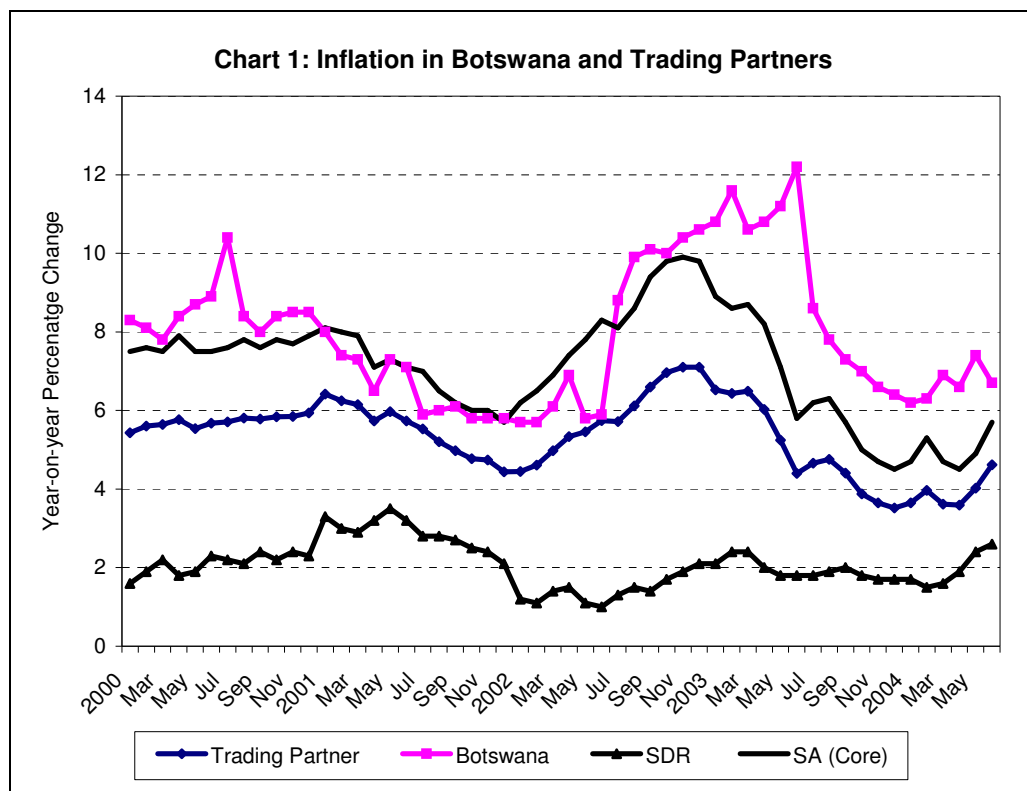
- 2.1 *In the first half of 2004, inflation varied between 6.2 percent¹ and 7.4 percent with an upward trend arising from the devaluation of the Pula, thus reversing the slowing in the second half of 2003. Domestic demand pressures were moderate in the first six months of 2004, with annual growth in credit to the private sector falling within the desired range while growth of government spending slowed in the first quarter of the year.*

¹ Unless otherwise stated, all inflation rates are year-on-year at the end of the period quoted.

2.2 The performance of the global economy continued to improve, underpinned by strong growth in productivity and demand in the USA, inducing investment and export growth in Japan and emerging Asian economies, while the euro area continued to lag behind. Global inflation eased to 2 percent in the first half of 2004, from 2.4 percent in the second half of 2003, despite the rise in fuel prices occasioned by fears of geopolitical tensions causing production and supply disruptions.

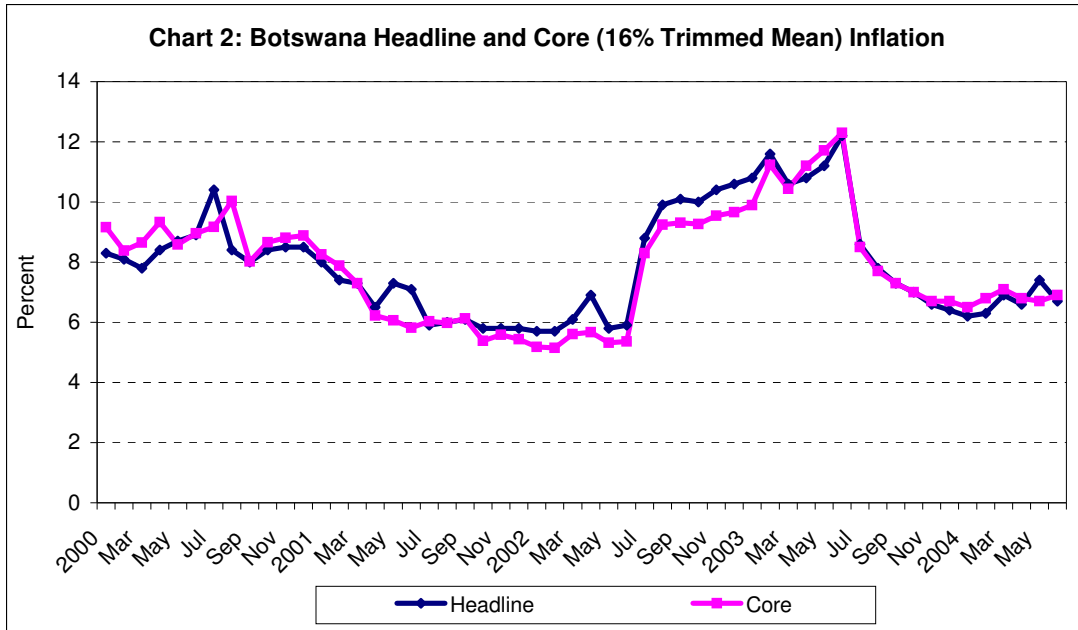
(a) International Inflation

2.3 Average inflation in Botswana's trading partner countries² rose to 4.6 percent in June 2004 from 3.5 percent (Chart 1) in December 2003 reflecting the increase in international oil prices and growth in demand. South African core inflation was 5.7 percent in June, a rise from 4.5 percent at the end of 2003, while headline inflation increased from 0.3 percent to 1.2 percent over the same period³. Meanwhile, SDR countries inflation rose from 1.7 percent in December 2003 to 2.6 percent in June.



² South Africa and SDR countries (Japan, USA, UK and the Euro zone).

³ The large difference between South African headline and core inflation is due to the slower rate of increase in mortgage rates (because of the reduction in interest rates in 2003), which are excluded from core inflation.



(b) Domestic inflation

2.4 Following a sharp decline in the second half of 2003, headline inflation rose in the first half of 2004, from 6.4 percent in December 2003 to 6.7 percent in June. Inflation rose marginally to 6.8 percent in July 2004. Core inflation⁴ increased to 6.9 percent in June from 6.7 percent at the end of 2003. The increase in headline inflation was mainly due to the impact of the February 2004 devaluation of the Pula on import prices. While a 0.5 percentage point increase in inflation between January and June, following a 7.5 percent devaluation appears low, prices rose by 5.6 percent in the six months to June 2004 compared to a much lower one percent increase in the second half of 2003, when inflation was declining sharply. The relatively small increase in inflation after the devaluation is, therefore, largely due to the fact that the rate of increase in prices was already falling prior to the devaluation, as a result of price developments in South Africa and moderating domestic demand pressures. It is also considered likely that domestic competitive pressures may have moderated the impact of the devaluation on prices. Without the devaluation, inflation in Botswana would be much lower than the current levels. Overall, the devaluation is estimated to have added 2 - 3 percentage points to inflation in the first half of 2004.

2.5 The impact of the devaluation on domestic inflation is shown in the faster increase in the annual rate of change in prices for imported tradeables compared to other categories. Prices of imports rose annually by 6.5 percent in June 2004 from 5.5 percent in December 2003, while inflation for domestic tradeables declined from 6.1 percent at the end of 2003 to 5.9 percent. Given the absence of

⁴ The Bank's preferred measure of core inflation is the trimmed mean. This approach removes the most extreme price changes, regardless of their source.

the devaluation impact, inflation for non-tradeables fell from 8.2 percent at the end of 2003 to 7.7 percent in June.

- 2.6 *Apart from the devaluation, increases in administered prices also added pressure to inflation in the first half of 2004. These included the 6 percent rise in electricity tariffs in March and, on average⁵, a cumulative 19.9 percent, 17.8 percent and 16.3 percent increase in petrol, diesel and paraffin, respectively, in April and June 2004. The Botswana Housing Corporation also raised rentals by an average of 10 percent in May, although the effect on inflation was minimal since there was an increase of a similar magnitude the previous year.*

(c) *Domestic credit*

- 2.7 *Annual growth in credit was 10.1 percent in June⁶, from 10 percent in December 2003 and 13.9 percent in June the previous year, and was below the Bank's desired range of 12 – 15 percent consistent with the inflation objective. This moderate growth rate in credit occurred against the backdrop of an average 15 percent increase in public service salaries, which in the past had resulted in an increase in demand for credit. The restrained growth in credit demand was in the context of a restrictive monetary policy and the erosion of real wages over the preceding two years during which there were no salary adjustments, as well as the recent increase in prices following the devaluation. It is also likely that increased debt burdens have contributed to the restrained credit demand by households, notwithstanding the public sector salary increases.*

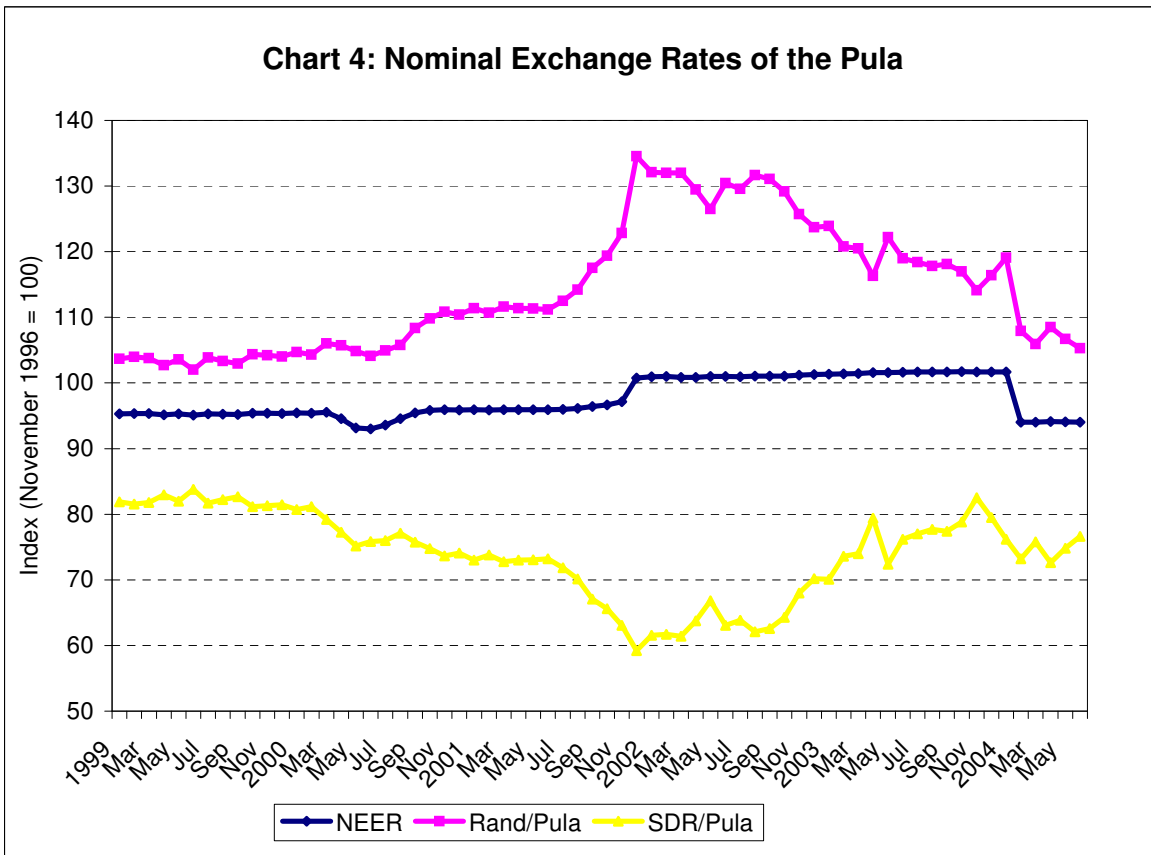
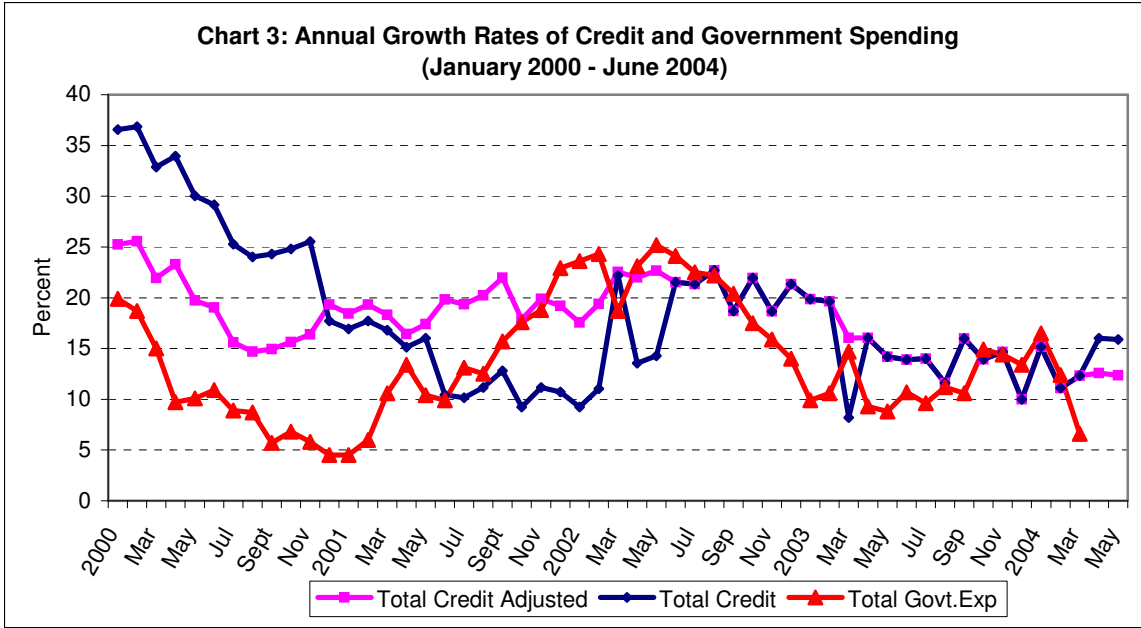
(d) *Government spending*

- 2.8 *Government expenditure for the first quarter of 2004 was 7 percent lower than spending in the comparable period last year, signifying a contraction in spending⁷. For the 2003/04 fiscal year (ending on March 2004), government spending grew by 6.6 percent annually, much lower than 14.7 percent recorded in 2002/03 and is, therefore, supportive of monetary policy.*

⁵ Averaged to reflect different rates of price increase across the regions.

⁶ The commercial bank credit growth figures have been adjusted to include lending by Investec Bank, following the takeover of the merchant bank by Stanbic Bank.

⁷ Government expenditure has been adjusted to exclude proceeds of the sale of PDSF loans which is classified as negative spending.

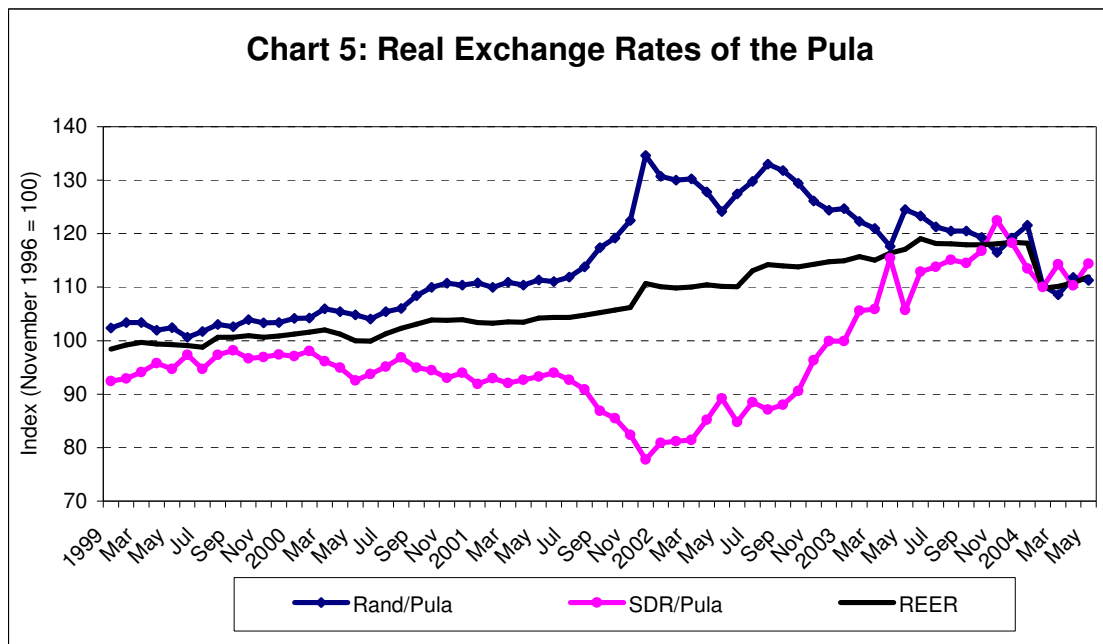


(e) *Nominal Effective Exchange Rate*

2.9 *The nominal effective exchange rate (NEER) of the Pula depreciated by 7.5 percent in the six months to June 2004, as a result of the devaluation of the Pula in February. Against individual currencies, the Pula depreciated by 3.6 percent vis-a-vis the SDR, mainly reflecting a 4.8 percent weakening against the US dollar, while it depreciated by 9.5 percent with respect to the rand.*

(f) *Real Effective Exchange Rate*

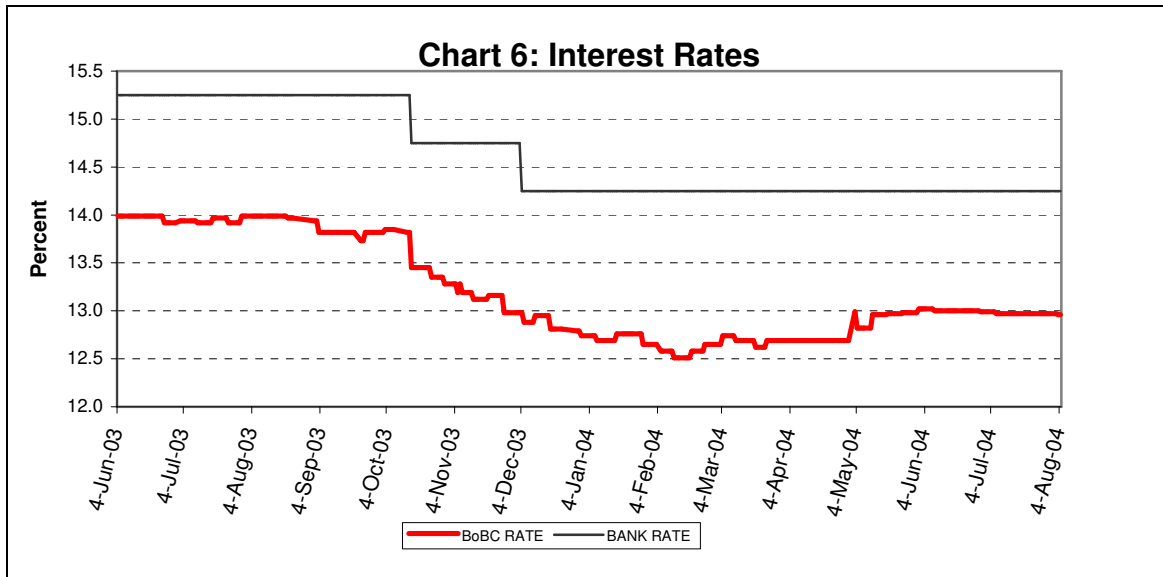
2.10 *As a result of the nominal devaluation, the real effective exchange rate (REER) of the Pula depreciated by 5 percent in the first half of the year, thus reversing most of the loss in competitiveness resulting from the recent appreciation. Bilaterally, the real exchange rate depreciated by 6.7 percent against the rand and by 0.1 percent against the SDR. The lower rate of depreciation of the real exchange rate against the SDR was due to the SDR inflation being significantly lower than that for Botswana in the first half of 2004.*



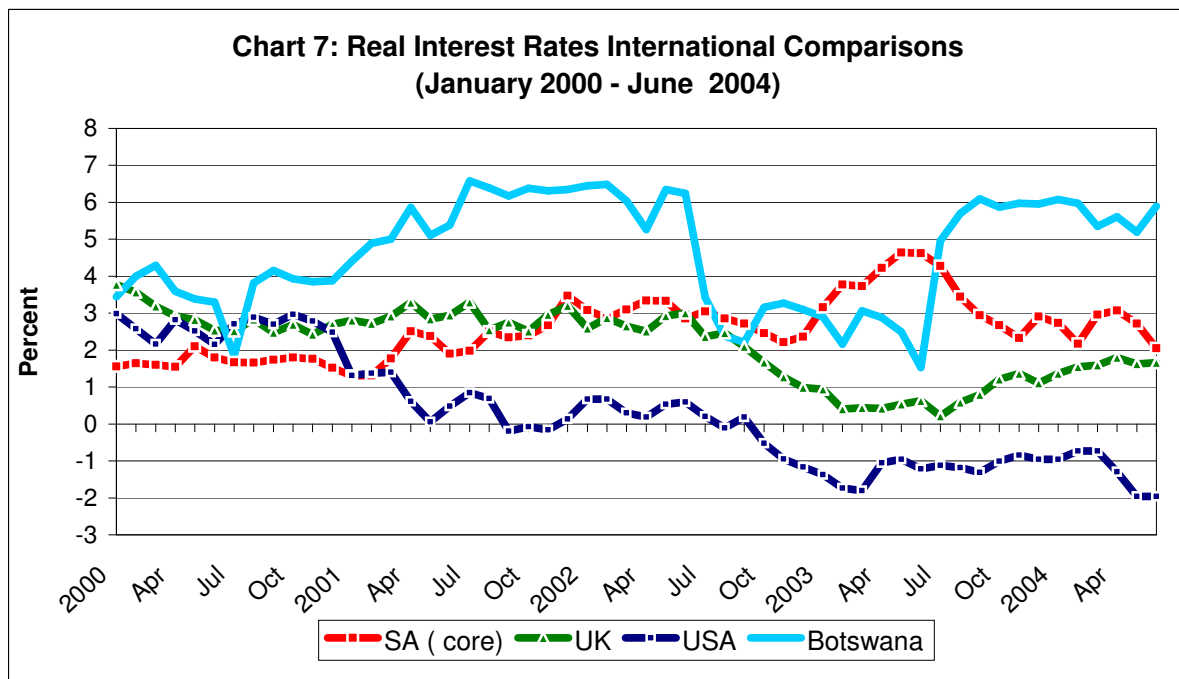
3. **Implementation of Monetary Policy**

3.1 *Monetary policy remained restrictive in the first half of the year, with the Bank Rate maintained at 14.25 percent, in order to restrain credit growth in the light of anticipated public service salary increase and to sustain expectations of low inflation following the devaluation of the Pula and increases in some administered prices. As a result, the prime rate for commercial banks was maintained at 15.75 percent and the average for the 88 day deposit rate at 9 percent, while short-term interest rates were largely stable in the first six months of 2004; in particular the three-month Bank of Botswana Certificate (BoBC) rate*

fluctuated between 12.58 percent and 12.99 percent. Open market operations supported the policy stance by absorbing excess liquidity through the sale of BoBCs in the domestic money market.



Note: Effective May 1, 2004, the three months BoBC rate is the weighted average of successful bid yields at auction while prior to that it was of the average of the offer and the bid price, hence it was called '3 Months BoBC Mid rate'. The change caused the reported BoBC rate to increase by 30 basis points (0,3 percent).



3.2 The real 3-month BoBC rate fluctuated between 5.2 percent and 6 percent (Chart 7) during the first half of the year and was 5.9 percent at the end of June 2004, marginally down from 6 percent at the end of December 2003, reflecting the rise in inflation. In an environment of relatively high nominal rates, real interest rates

in Botswana continue to be much higher than comparable rates in South Africa⁸, the UK and USA.

4. Inflation Outlook for the rest of 2004

(a) External Factors

4.1 The performance of the world economy continues to improve and global output growth is forecast to increase from 3.9 percent in 2003 to 4.6 percent in 2004⁹. While global inflation remains low and stable, there is an upside risk due to the rise in economic activity and the effect of the recent sharp increase in international oil prices arising from geopolitical risks to the supply of oil in an environment of rising demand. Inflation is forecast to increase in many of the major economies in the short to medium term and, in response, global interest rates are being raised to mitigate inflationary pressures.

4.2 In South Africa, an increase in real wages, the effect of the interest rate cuts made in 2003 and accelerating government expenditure are expected to boost output growth to 2.4 percent in 2004, compared to 1.9 percent in 2003. Meanwhile, inflation remains low due to the combined effect of monetary and fiscal discipline in the recent past and the appreciation of the rand, with the South African Reserve Bank's target measure of inflation, CPIX, staying within the target range of 3 – 6 percent since September 2003. However, due to the increase in international fuel prices, CPIX inflation may rise above the target range in the short term, but this is expected to be temporary as it is anticipated that demand and supply conditions in the international oil market will balance out over the medium to longer term and bring about a reduction in oil prices.

(b) Domestic Factors

4.3 Domestic demand pressures, as indicated by the growth rates of Government expenditure and credit to the private sector, continue to be moderate and should remain consistent with the inflation objective during the rest of 2004. Despite the subdued demand pressures, inflation was generally on an upward trend in the first half of the year mainly due to the impact of the devaluation of the Pula (in February 2004) on import prices. Going forward, the impact of the devaluation on inflation is expected to ease but there are upside risks to import prices due to the forecast increase in global inflation arising from growth in demand and the rise in fuel prices. However, administered prices are the main threat to domestic inflation, in particular the second round effects of the June increase in fuel prices, and the increase in public transport fares in August, which are expected to add approximately 0.5 percent to inflation. In addition, an increase in water tariffs is expected in September.

⁸ South African real rate deflated by core inflation.

⁹ Growth figures obtained from the April 2004 World Economic Outlook published by the International Monetary Fund.

- 4.4 *The inflation objective of 4 - 7 percent announced in the 2004 MPS was set slightly above the forecast trading partner inflation, in order to allow room for the economy to adjust to the higher imported inflation arising from the devaluation, while ensuring that the potential gain in competitiveness that the devaluation is intended to achieve will not be eroded by higher inflation. Despite the widening of the range, a restrictive monetary policy was maintained to prevent higher cost of imports feeding through to prices of domestically produced goods and services, in particular by ensuring that demand pressures are contained, and inflation expectations, influenced by increases in administered prices during the year, do not accelerate.*
- 4.5 *The current trends in the growth rates of credit and government spending suggest that the inflation objective for the year remains appropriate for the rest of the year, notwithstanding external inflationary pressures and the expected increases in administered prices during the remainder of the year. In the short-term, domestic core inflation is expected to remain close to the upper limit of the inflation objective, although headline inflation may be somewhat higher as a result of increases in fuel prices and public transport fares.*

5. **Summary and Conclusions**

- 5.1 *Following a sharp fall in the second half of 2003, inflation edged upwards in the first six months of 2004 due to the devaluation of the Pula and increases in some administered prices. For the remainder of 2004, there are cost-push pressures on inflation arising from further increases in administered prices and possible second round effects of the recent fuel price increases. However, moderate domestic demand pressures, as indicated by restrained growth in private sector credit and government spending, should help to offset the cost-push pressures and contribute to a possible easing of inflationary pressures in the economy.*
- 5.2 *Externally, inflation in the major economies is forecast to rise as economic activity improves, but this is unlikely to exert significant pressures on domestic prices, in particular because of preemptive policy responses by the major central banks. In South Africa, inflation is expected to be within the target range of 3 – 6 percent, with any breach of the target range being temporary.*
- 5.3 *The task for the current policy stance is to sustain the moderate growth rates for credit and, therefore, demand consistent with the inflation objective. There is also the need to maintain expectations of low inflation given the threat posed by the increase in administered prices and global inflation. Therefore, for the remaining part of the year, the Bank will adhere to the current inflation objective of 4 – 7 percent, and to the 12 – 15 percent growth in private sector credit. The Bank will continue to monitor the relevant indicators and take appropriate policy action, as necessary, in light of both financial and price developments during the rest of 2004.*